

**Testimony of the Honorable Michael M. Reyna
Chairman and Chief Executive Officer
Farm Credit Administration
Before the Committee on Agriculture
U.S. House of Representatives
October 16, 2003**

Mr. Chairman, members of the committee, I am Michael Reyna, Chairman and Chief Executive Officer of the Farm Credit Administration (FCA or agency). Joining me are my colleagues on the FCA Board, Doug Flory and Nancy Pellett.

I am pleased to be here with you today to discuss the changing structure of agricultural cooperatives and the challenges that cooperatives face as they seek to increase the income of their farmer-members while, at the same time, find new ways to finance their operations. These challenges, and how Congress chooses to address them, are of prime importance to the FCA and the Farm Credit System (System) institutions we examine and regulate.

America's farmers, ranchers, agricultural cooperatives, and rural utilities own and govern the System institutions that extend credit to them. The System itself is a group of agricultural cooperatives that fulfills its Congressional mandate to provide sound, dependable, and affordable credit to America's agricultural producers, their cooperatives and rural America.

I am pleased to report to you the financial condition of the System is strong despite the economic challenges and difficulties currently facing agriculture and rural America. The System's financial strength and expertise in financing agriculture enables it to help farmers, ranchers and their cooperatives overcome these challenges so that Americans will always have abundant food and fiber at affordable prices, and America will remain a major food and fiber supplier to the world.

THE FARM CREDIT SYSTEM

As you are aware, the System has played a prominent role in financing American agriculture and rural America since Congress created it in 1916. The System is the oldest Government-sponsored enterprise (GSE), and it is the only GSE that engages in retail lending. The mission of the System is to serve agriculture and rural America. In fact, the preamble to the Farm Credit Act of 1971 (Act) states that the purpose of the law is to “provide for the farmer-owned cooperative system of making credit available to farmers, ranchers and their cooperatives, for rural residences, and to associations and other entities upon which farming operations are dependent, to provide for an adequate and flexible flow of money into rural areas, and to . . . meet current and future rural credit needs”

The first section of the Act states that “the farmer-owned cooperative Farm Credit System [is] designed to accomplish the objective of improving the income and well-being of American farmers and ranchers by furnishing sound, adequate, and constructive credit and closely related services to them, their cooperatives, and to selected farm-related businesses necessary for efficient farm operations.”

Today, System banks, associations, and service corporations serve all 50 states and the Commonwealth of Puerto Rico. As of October 1, 2003, the System consisted of 112 institutions. Four Farm Credit Banks and one agricultural credit bank (ACB) fund and discount loans that 99 System associations make directly to farmers, ranchers, aquatic producers and harvesters, farm-related service businesses, and rural homeowners. The Farm Credit banks also fund and discount loans that 29 non-System other financing institutions (OFIs), such as commercial and community banks and their affiliates, agricultural credit corporations and production livestock associations, make to farmers, ranchers, and other eligible borrowers.

The Federal Agricultural Mortgage Corporation (Farmer Mac) is another federally chartered GSE that Congress established in 1987 to operate a secondary market for agricultural real estate and rural home mortgages. The Farmer Mac secondary market operates through a network of agricultural lenders, originators, and sellers, among them commercial banks, System banks and associations, life insurance companies and mortgage companies. The System also includes five service corporations that are chartered under the Act, and are owned by various System banks and associations. These service corporations perform various functions and services for their owners, other than extending credit or providing insurance services.

The agricultural credit bank (ACB), CoBank, lends to agricultural and aquatic cooperatives, rural utilities, and to the parent corporations, subsidiaries and affiliates of these borrowers. CoBank also finances the export and import of agricultural commodities and supplies, and it provides international banking services to agricultural cooperatives and their counterparties.

All five System banks own the Federal Farm Credit System Banks Funding Corporation (Funding Corporation), which sells debt securities to investors. Proceeds from the sale of these securities fund the loans System banks and associations make to their borrowers. Earnings and repayment from these loans enable System banks to repay the principal and interest on System debt securities.

The United States government is not liable for the repayment of System debt securities. Instead, the Farm Credit System Insurance Corporation (FCSIC), which Congress established and the System funds, insures the principal and interest on all consolidated System debt securities. The FCSIC insurance fund protects investors and taxpayers from loss. My colleague,

Doug Flory, serves as the Chairman of FCSIC.

FARM CREDIT ADMINISTRATION

All System institutions are chartered, regulated, and examined by the FCA, which is an independent agency in the Executive branch of the Federal government. A full-time, three-member board governs the FCA. The President, with the advice and consent of the Senate, appoints each FCA Board member for a six-year term. The President also designates the Chairman of the FCA, who serves in this capacity for the duration of the board member's term. FCA is responsible for ensuring that all System institutions operate safely and soundly and comply with applicable laws.

The Act requires the FCA to annually report to Congress on the condition of the System, and the manner and extent to which the System is carrying out the Act's purposes and objectives. The Act also authorizes the FCA to consult with Congress about legislative initiatives that could affect the System's ability to finance farmers, ranchers, and their cooperatives.

COOPERATIVES PROVIDE IMPORTANT BENEFITS TO AGRICULTURE AND RURAL AMERICA

Cooperatives play a crucial role in making American agriculture prosperous, productive, and efficient. They increase the economic bargaining power of farmers, which in turn, strengthens the agricultural economy and improves living conditions in rural areas. Cooperatives were instrumental in bringing electricity and modern telecommunication services to rural areas. Essentially, cooperatives increase the sales revenue of farmers and lower the costs farmers pay for supplies and business services.

For example, marketing cooperatives help farmers increase the price they receive for their raw products while processing cooperatives add value to commodities their members

produce. Other cooperatives reduce farm expenses by selling supplies, inputs, and business services to their farmer-owners at lower prices. Farmers who choose not to become members of cooperatives also benefit from the competition and efficiencies cooperatives bring to rural America.

Cooperatives also benefit the rural communities in which they do business. Earnings in the form of patronage are returned to farmers who participate in the local economy. Cooperatives strengthen the economic base of the local community by adding to the tax base, creating new jobs, and spurring retail sales and services. Cooperative members understand their importance to the local community where decisions are made at the local level.

Consumers also benefit from agricultural cooperatives. Cooperatives play an important role in providing consumers with food and fiber that is plentiful, safe, and affordable. Cooperatives also help provide consumers with more choices, as they are often at the forefront in introducing new or specialty food or other products into the market, such as ethanol. Much of the food and fiber that America exports is sold by farmer cooperatives.

All in all, cooperatives are a vital and integral part of rural America.

COOPERATIVE STRUCTURE AND PRINCIPLES

The unique structure of cooperatives strengthens the market power of farmers so they can earn more and live better. Unlike other business structures, cooperatives are owned and controlled by the people who use their services. As a result, they operate for the mutual benefit of their member-owners. Characteristics of traditional farmer cooperatives include the following:

- Agricultural producers are a large majority of the voting members;
- Each member has only one vote, regardless of the amount of equity capital owned;
- Members earn patronage based on the amount of business they do with the cooperative,

- Dividend payments on equity capital are restricted, and
- The cooperative does more business with members than non-members.

Historically, cooperatives developed as an alternative to investor-owned agribusinesses, which were perceived as paying farmers too little for raw commodities and then charging consumers high prices for value-added food products. Cooperatives were also thought to give farmers and ranchers more power to control speculation in agricultural commodities and reduce surpluses that drive down the price of farm products. Besides empowering farmers and ranchers, many believed cooperatives would make the marketing and distribution systems for agricultural products more efficient.

For more than 80 years, Congress has sought to preserve and enhance the benefits cooperatives bestow on farmers, their domestic and foreign customers, and America as a whole by enacting laws that enable agricultural cooperatives to grow and prosper. Congress devised a public policy that grants cooperatives certain legal protections, tax benefits, and other advantages not conferred on investor-owned agribusinesses.

For example, the Capper-Volstead Act exempts agricultural cooperatives that process, prepare, market, or otherwise handle agricultural commodities in interstate or international commerce from antitrust laws. Subchapter T of the Internal Revenue Code protects the earnings of agricultural cooperatives from double taxation. Patrons pay taxes on earnings that are passed through to them by their cooperatives. Cooperatives are generally exempt from many of the filing requirements under securities laws. Cooperatives are eligible under the Farm Credit Act to borrow from the Farm Credit System. As a result, farmer cooperatives have direct access to GSE funding that their competitors, which are investor-owned agribusinesses, generally lack.

The Cooperative Marketing Act authorizes USDA to offer cooperatives a wide array of technical services. The Rural Business-Cooperative Service in USDA provides research and

technical assistance that enables cooperatives to improve their operating efficiencies and develop business strategies to compete successfully in the marketplace. This, in turn, strengthens the economic viability of both farmers and rural communities.

COOPERATIVES IN TODAY'S AGRICULTURAL ECONOMY

United States Department of Agriculture (USDA) statistics detail the role of farmer cooperatives in the agricultural economy. The share of overall farm commodities marketed through cooperatives has been fairly steady over the past five years, with a slight decline from 28.4 percent in 1997 to 27.7 percent in 2001. During this period, the share of business volume cooperatives held in agricultural industries was 83 percent for dairy products, 52 percent for sugar, and 49 percent for wool. Although the market share cooperatives held in most industries increased slightly during this period, the percentages dropped for grain and oilseeds by 5 percent each in the past five years.

USDA statistics also reveal cooperatives handle more than a quarter of farm supplies and inputs sold in the United States. Major inputs handled by cooperatives declined from 29 percent at the end of 1997 to 26 percent at the end of 2001. In terms of business volume, cooperatives handled 46 percent of petroleum, 45 percent of fertilizer, and 34 percent of crop protectants sold to farmers.

Although the number of farmer cooperatives declined by 25 percent in the past decade, the net business volume of cooperatives actually increased. In 1992, the net business volume of 4,315 cooperatives totaled \$79.3 billion. In 2001, the net business volume of 3,229 cooperatives was \$84.9 billion, as adjusted for inflation.

No information was available to determine whether farmers have been reducing their use of the cooperative form in recent years. FCA did, however, conduct a limited survey in which

we contacted the ten states with the greatest number of cooperatives to identify annual trends in new cooperative filings. Our staff found no consistent trend in the number of new filings over the period 1993 to 2003. While half of the states did display a declining trend in the number of cooperative filings, two states displayed an increasing trend and one state showed no change. Two states were unable to provide the data. A broader survey, as well as further study, is warranted.

CHALLENGES FACING COOPERATIVES

Although cooperatives clearly strengthen the agricultural economy and improve life in rural America, they face new challenges as farmers in America struggle to compete in a global economy. Concerns have been raised that traditional cooperatives are not resilient enough to endure the economic changes facing agriculture today and to help farmers overcome new challenges. The cooperative movement developed at a time when farmers comprised half the American population and farmer-owned value-added enterprises were rare. Today, farmers comprise less than 2 percent of the American population. This means there are fewer farmers who can join and contribute financial resources to cooperatives.

The farmer's share of the consumer's food dollar has been steadily declining. Value-added enterprises are one of the best ways for farmers to increase their income because they provide a way for farmers to earn a greater share of the retail food dollar. However, the American food distribution system is increasingly concentrated, vertically integrated, and capital intensive, which makes it more difficult and costly for farmers to own and control value-added enterprises. Typically today, farmers struggle to find sufficient capital to enable them to invest in their own value-added enterprises.

When farmers cannot raise sufficient capital on their own, they need to turn to outside sources of equity. To attract outside equity capital or increase their business with nonmembers, some farmer groups are forming hybrid organizations or restructuring existing cooperatives. FCA staff identified numerous examples of value-added cooperatives that had changed to the Limited Liability Corporation (LLC) form or that had formed a joint venture LLC with other cooperatives or Subchapter C firms. In addition, some groups of farmers and ranchers have chosen to form new value-added enterprises such as LLCs rather than cooperatives.

LLCs offer many advantages that cooperatives do not. For example, LLCs attract outside investors by giving them a say in management and a return in proportion to their investment. In contrast to traditional cooperatives, LLCs may do a significant amount of business with farmers who are not willing or able to acquire an ownership interest in the enterprise. LLCs provide the single tax advantage to both farmers and investors. LLCs also offer tax advantages that give these enterprises increased flexibility to do substantial business with farmers who are not members.

While a few well-established cooperatives have been successful in raising outside equity, most investors have little incentive to invest in agricultural cooperatives. This is especially true for start-up cooperatives. Outside investors are not farmers and, therefore, they cannot become members of traditional cooperatives. Since outside investors cannot be members, they can neither vote nor control a cooperative organization. This is a strong disincentive for outsiders to invest in cooperatives. In addition, dividend payments on equity investments are restricted because patronage payments to members are the primary way cooperatives distribute their earnings. Thus, outside investors would not receive a return on their investment that is commensurate with the risk they take.

Recognizing the limitations of the traditional cooperative structure, Wyoming and Minnesota enacted new laws that allow farmers and investors to join together to form new types of cooperatives. These cooperatives can best be described as hybrids between traditional cooperatives and LLCs. The two state laws are not identical, and their treatment of certain issues differs. However, the laws of both states allow farmers and investors to become members of a cooperative. The membership is divided into two separate classes: farmers-patrons and investors. Generally, patrons vote on a one-member, one vote basis while investors voting rights are proportional to their investment. Members receive patronage refunds based on the amount of business they do with the cooperative. Investors are allocated financial returns in proportion to their capital contributions.

The Minnesota law requires that farmers have at least 50 percent of the voting control of the cooperative. It also specifies that farmers are entitled to 60 percent of the financial returns unless they vote as a block to accept a lesser amount, which may never be less than 15 percent. Under the Wyoming statute, patrons must elect at least one member to the board of directors. Directors elected by patrons must have at least 50 percent of the voting power on the Board. The Wyoming statute also requires patrons to receive at least 15 percent of the cooperative's profit allocation and distribution. Both laws allow cooperatives to avoid double taxation for both their patrons and investors.

These laws are newly enacted and, at this stage, it is unknown how many traditional cooperatives plan to convert into hybrid cooperatives, or how many entities will be formed under these new state laws. Other states are considering similar legislation that would allow hybrid cooperatives to form under their laws. Cooperatives formed under the laws of one state usually can register to conduct business in other states.

The success of hybrid cooperatives will depend on whether farmers and investors can work together. Potentially, the two groups have different objectives. These differing objectives could be a source of conflict, and boards of directors may find it a challenge to balance the needs and expectations of both groups. Whether hybrid cooperatives prove successful and, thus, become a model business structure in the future ultimately depends on their ability to reconcile potential conflicts between farmers and investors. However, it is important to note this hybrid structure might prove beneficial in helping farmers attract needed capital for value-added enterprises and to increase their incomes since investors want to maximize profits.

FARM CREDIT SYSTEM FINANCING FOR COOPERATIVES AND OTHER VALUE-ADDED BUSINESS OWNED BY FARMERS

In addition to financing production agriculture, the System extends credit to a wide array of businesses owned and controlled by farmers and ranchers that add value to agricultural commodities. However, some value-added businesses eligible to borrow from the System are not cooperatives. Value-added businesses are ineligible to borrow directly from the System if they (1) are owned and controlled by investors, rather than farmers, and (2) produce none of the agricultural products that they process and market. In this context, the System is a GSE that finances value-added businesses firmly anchored to the farming operations of farmers and ranchers. Investor-owned agribusinesses generally obtain credit elsewhere.

Several provisions of the Act authorize certain System institutions to finance cooperatives and other farmer-owned businesses. I would like to briefly review those authorities for you now.

Title III of the Act grants banks for cooperatives and agricultural credit banks broad authority to extend credit and financially related services to cooperatives, their parent entities and

subsidiaries. Today, CoBank, ACB is the only System institution that operates under title III of the Act. The Act authorizes CoBank to lend to any cooperative that has powers to (1) process or market agricultural or aquatic products, (2) sell farm and aquatic supplies, or (3) furnish farm or aquatic business services to its members.

Eligible cooperatives also must operate on a “cooperative basis.” As explained earlier, “cooperative basis” means a cooperative is owned and controlled by the farmers that use its services. Additionally, cooperatives transact most of their business with their members, and profits are returned to members on the basis of patronage rather than the amount of equity owned.

The Act and FCA regulations establish specific criteria for determining whether eligible borrowers operate on a “cooperative basis.” First, farmers, ranchers, aquatic producers and harvesters, or other cooperatives generally must hold at least 80 percent of the voting control of a cooperative, although the voting control threshold for service cooperatives and certain supply cooperatives is 60 percent or higher.

Next, an eligible cooperative borrower must conform to either of the following conditions: (1) no member has more than one vote because of the amount of stock or membership capital owned; or (2) the cooperative restricts dividends on stock or membership capital to 10 percent each year or the maximum percentage permitted under applicable state law, whichever is less. Finally, the cooperative must conduct more business with members than non-members, although transactions with the government are excluded from this calculation.

Since 1996, the law has allowed CoBank to continue financing existing borrowers who no longer operate on a “cooperative basis” as long as farmers, ranchers, aquatic producers and harvesters, or other eligible cooperatives continue to hold more than 50 percent of the voting

control. This provision preserves access to GSE funding for existing borrowers owned and controlled by farmers even though they no longer operate on a “cooperative basis.”

The Act and FCA regulations also confer eligibility on other legal entities that are the parents, subsidiaries, or other affiliates of cooperatives. For example, a legal entity that is the parent of an eligible cooperative may borrow from the ACB if it (1) holds more than 50 percent of the voting control of the cooperative, and (2) uses the loan proceeds to fund the activities of its cooperative subsidiary. Similarly, CoBank may finance subsidiaries and other entities owned by an eligible cooperative, but the Act and FCA regulations restrict the amount of financing if cooperatives own less than 50 percent of the borrowing subsidiary or affiliate.

System direct lender associations also have authority to finance farmer-owned businesses that process and market agricultural commodities, whether or not they operate on a cooperative basis. Two provisions of the Act allow System associations to extend credit to *bona fide* farmers, ranchers, and aquatic producers and harvesters for basic processing and marketing “directly related” to the borrowers’ agricultural or aquatic operations and those of other eligible producers.

An FCA regulation implements the Act by requiring farmers to hold more than 50 percent of the voting stock or equity of a separate legal entity that process and markets their produce. By law, farmers must supply throughput to the processing and marketing operation. The Act and regulation limit the amount of credit that all direct lender associations affiliated with the same Farm Credit bank can extend to borrowers who supply less than 20 percent of the throughput.

Such loans, in the aggregate, cannot exceed 15 percent of the total outstanding retail loans that associations affiliated with the same bank made during the preceding fiscal year.

Although associations can and do finance cooperatives under their processing and marketing authorities, they also have the flexibility to extend credit to other farmer-controlled entities that add value to raw agricultural commodities, but otherwise do not operate on a cooperative basis.

During the 1990s, Congress twice amended the Act so System banks and associations could “participate” in extensions of credits that non-System lenders make to “similar entities.” By law, similar entities are ineligible to borrow directly from FCS banks and associations but they derive most of their income from, or have most of their assets invested in activities that are functionally similar to the operations of eligible borrowers.

Essentially, this authority enables the System to participate in loans non-System lenders make to investor-owned agribusinesses that are not extensions of a farming, ranching, or aquatic operation. The Act prohibits System institutions, individually or collectively, from acquiring 50 percent or more of the principle amount of the credit, and similar entity participations may not exceed 15 percent of the total assets of any System bank or association. The Act also limits an institution’s participations in a single credit risk to 10 percent of its total capital.

NEW FEDERAL LEGISLATION

The FCA is aware CoBank is developing a legislative proposal that would give it more flexibility to finance cooperatives as they adjust to changing market conditions. As we understand this proposal, CoBank could finance entities in which farmers hold at least 50 percent of the equity or voting control, or are designated as cooperatives by state law. And, under this proposal, existing cooperatives would continue to be eligible for CoBank financing as long as farmers maintain at least 50 percent of the ownership or control of the customer. The proposal would allow CoBank to extend new credit for a five-year transition period to an existing borrower that subsequently changes its structure and becomes ineligible.

Depending upon the specific language ultimately adopted by Congress, this proposal may well be the change needed to save the cooperative way of doing business for farmers, ranchers and their cooperatives. It may also prove to strengthen farmers' and ranchers' income and rural America.

Congress must ultimately decide the scope of the System's lending powers. The FCA is prepared to implement and enforce any policy Congress enacts. We ask that any new legislation clearly delineate the extent of CoBank's new authority and expressly authorize the FCA to enact regulations that implement new powers CoBank is granted. The FCA is ready to offer assistance in crafting the specifics of any new legislation, and we look forward to working with this Committee as it considers issues important to America's farmers, ranchers, their cooperatives, and rural America.

I thank you for this opportunity to testify.